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July 11, 2004

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Re: Docket No. R-1193; Risk-Based Capital Standards: Trust Preferred Securities and the Definition of Capital

Dear Ms. Johnson:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to comment on the proposal by the Board of Governors of the Federal Reserve System (Board) to allow the continued inclusion of outstanding and prospective issuances of trust preferred securities in the tier 1 capital of bank holding companies, subject to stricter quantitative limits and standards.

Background

The Board's current risk-based and leverage capital guidelines for bank holding companies (BHCs) allow BHCs to include in their tier 1 capital the following items: (1) common stockholders' equity; (2) qualifying noncumulative perpetual preferred stock (including related surplus); (3) qualifying cumulative perpetual preferred stock (including related surplus); and (4) minority interests in the equity accounts of consolidated subsidiaries. Qualifying cumulative preferred stock is limited to 25% of these core capital elements.

In 1996, the Board approved the inclusion in BHC's tier 1 capital of minority interest in the form of trust preferred securities. Trust preferred securities are undated cumulative preferred securities issued out of a special purpose entity, usually in the form of a trust, in which the BHC owns all of the common stock. The trust preferred securities allow for at least twenty consecutive quarters of dividend deferral, after which the investors have the right to take hold of the sole asset in the trust, a deeply subordinated

[1] The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to protecting the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace. For more information, visit ICBA's website at www.icba.org.

note issued by the BHC. The note, which is subordinated to all obligations of the BHC other than its common and preferred stock, has terms that generally mirror those of the trust preferred securities, except that the subordinated debt has a fixed maturity of at least 30 years. Because trust preferred securities are cumulative, the Board limits them, together with directly issued cumulative perpetual preferred stock, to no more than 25% of a BHC's core capital elements.

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46, Consolidation of Variable Interest Entities (FIN 46) which held that trust preferred securities could no longer be treated as minority interest in the equity accounts of a consolidated subsidiary on a BHC's consolidated balance sheet. Subsequently, the Board stated that it was reexamining its regulatory capital treatment of trust preferred in light of the change in GAAP accounting but reiterated its longstanding direction that BHCs are required to follow GAAP for regulatory reporting purposes.

Proposed Rule

Transition Period Ending March 31, 2007. The Board is now proposing that BHCs be permitted to continue to count the aggregate amount of qualifying trust preferred securities and qualifying cumulative perpetual preferred stock as tier 1 capital through March 31, 2007 subject to current restrictions (e.g., no more than 25% of core capital elements). During the transition period, BHCs with "restricted core capital elements" in excess of the proposed limits must consult with the Federal Reserve on a plan for ensuring that the bank is not unduly relying upon these elements in its capital base and, where appropriate, for reducing such reliance.

After March 31, 2007. After the transition period, the aggregate amount of trust preferred securities **and** other "restricted core capital elements" could not exceed 25% of the amount of all "core capital elements", **net of goodwill**. "Restricted core capital elements" would include trust preferred securities, cumulative perpetual preferred stock, and Class B and Class C minority interests, which are new categories of minority interests set forth in the proposal.[2] By netting goodwill from the calculation of the 25% limit, the Board is tightening the current 25% limit, which currently is determined on a basis that does not deduct goodwill. Excess amounts of trust preferred securities would be treated as tier 2 capital, subject to certain limitations.[3]

Phase-out Prior to Maturity**.** Under the proposal, beginning with the period commencing five years prior to maturity (generally, 25 years after issuance), the entire

[2] Under the proposal, minority interest related to qualifying cumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or a foreign bank subsidiary would be a Class B minority interest subject to limitation within tier 1 capital, but not subject to a tier 2 sublimit. Minority interest in the form of qualifying common stockholders' equity or qualifying perpetual preferred stock (and related surplus) in a consolidated subsidiary that is neither a U.S. depository institution nor a foreign bank would be a Class C minority interest. A Class C minority interest would be subject to a tier 2 sublimit. A Class A minority interest is qualifying common or noncumulative perpetual preferred stock directly issued by a consolidated U.S. depository institution or foreign bank subsidiary.

[3] The Board is proposing that amounts of qualifying trust preferred securities and Class C minority interest in excess of the 25% limit be included in tier 2 capital but be limited, together with subordinated debt and limited-life preferred stock, to 50% of tier 1 capital.

amount of trust preferred securities must be removed as an element of tier 1 capital, and may be included in tier 2 capital, subject to a further phase-out period.

Criteria for Qualifying Trust Preferred Securities: The Board's proposal specifies the criteria trust preferred securities must meet to be eligible for inclusions in tier 1 capital. Under these criteria, which the Board has broadly used since 1996, a BHC must consult with the Federal Reserve prior to issuing trust preferred securities. Such consultation would normally be undertaken with the BHC's District Reserve Bank. Qualifying trust preferred securities must be undated and provide for a minimum of twenty consecutive quarters of dividend deferral, as well as a call at the BHC's option commencing no later than ten years from issuance. The sole asset of the trust must be a subordinated note issued by the BHC, which must have a minimum maturity of thirty years and must be subordinated to all other subordinated debt of the BHC. The terms of the subordinated note must conform to the requirements of the Board's subordinated debt policy statement, although the note may become due and payable upon default following the deferral of dividends for more than 20 consecutive quarters. With regard to trust preferred securities issued by a BHC to a pool, the proposal sets forth the longstanding Board policy that the BHC may not purchase securities issued by that same pool.

ICBA Supports the Board's Proposal

ICBA applauds the Board's proposal to retain trust preferred securities in the tier 1 capital of bank holding companies. ICBA represents approximately 5,000 community banks throughout the United States. Many of these community banks are owned by bank holding companies that have a limited ability to access the capital markets. For these community holding companies, the issuance of trust preferred securities has been an attractive method for raising capital, particularly since the introduction of pooled offerings. As the Board noted in its proposal, poolings of trust preferred securities have permitted small bank holding companies for the first time to access the capital markets for tier 1 capital, which larger bank holding companies have long enjoyed. In addition to affording great liquidity and diversification of risk for the investors, the pool approach reduces each holding company's transaction costs as well as the minimum amount of trust preferred securities that each holding company must issue. Since 1996 when the Federal Reserve relaxed its capital requirements, approximately 820 BHCs both large and small have issued over $77 billion of trust preferred securities, many of which have been through pool arrangements.

A regulatory change in the treatment of trust preferred securities would have had an immediate impact on community banks' ability to expand their capital and, in turn, would have affected their ability to lend. Community banks play not only a strong role in consumer financing in this country but also an important role in small business financing. Commercial banks are the leading suppliers of credit to small business, and community banks account for a disproportionate share of total bank lending to small business.[4] At a time when many smaller community banks are just beginning to have access to the market, a change in the treatment of trust preferred securities would have had a direct and immediate impact on small business lending.

[4] Community banks account for 33 percent of small business loans, more than twice their share (15%) of banking assets.

Furthermore, while large banks that have issued trust preferred securities might have been able to adjust to a change in the treatment of trust preferred securities by issuing other kinds of preferred or common stock, community bank holding companies would not had the same options. In many cases, their only access to the market is through the issuance of trust preferred securities. For those community holding companies that already include trust preferred securities as part of tier one capital, their only option would have been to reduce their capital and curtail their expansion and lending activities.

Finally, as the Board noted, the overall supervisory experience with trust preferred securities has been very positive. Trust preferred securities have proven to be a useful source of capital funding for BHCs, which typically downstream the proceeds in the form of common stock to subsidiary banks, thereby strengthening the banks' capital bases. Trust preferred securities are always available to absorb losses throughout the BHC and do not affect the BHC's liquidity position. When BHCs have been in deteriorating financial conditions, they have merely deferred dividends on their trust preferred securities to preserve their cash flow.

ICBA Supports the Proposed Definitions of Qualifying Capital and Restrictions on Minority Interests of Consolidated Subsidiaries

ICBA agrees with the Board that the proposed definitions of "core capital elements" and "restricted core capital elements" are reasonable and appropriate. A BHC's minority interest in a consolidated U.S. depository institution should take priority over the minority interest in a typical operating subsidiary since the latter does not stave off technical insolvency or provide capital support for the broader consolidated organization. Therefore, it makes sense to include trust preferred securities with Class B minority interests (cumulative perpetual preferred stock issued by a depository institution) and Class C minority interests (minority interests in an operating subsidiary) as part of proposed definition of "restricted core capital elements" and to propose a limit of 25% of core capital elements (net of goodwill) for these categories of minority interests.

However, we are concerned that the deduction of goodwill from the calculation of the 25% limit will adversely impact those BHCs that have been active acquirers of banks and branches and that have accumulated significant amounts of goodwill. Not only is the term of most trust preferred securities thirty years, but the capital plans that are generally submitted to regulatory authorities in connection with a proposed acquisition often extend for twelve years or more. To require banking organizations that have made commitments under previous guidelines to adhere to more stringent rules in a less than three-year transitional period seems overly harsh. As noted below, we recommend a five-year transition period rather than a three-year transition period to allow those BHCs that have been active acquirers of banks and branches a chance to comply with the new calculation.

ICBA Recommends Several Changes to the Proposal

Although ICBA generally supports the Board's proposal to retain trust preferred securities as tier 1 capital, we recommend the following changes:

Transition Period. First, we recommend a five-year transition period for BHCs, or until March 31, 2009, to meet the new, stricter limitations rather than a three-year transition period that would end on March 31, 2007 for those BHCs that have been active acquirers of banks and branches. As noted above, this would allow those BHCs that have made acquisitions and have accumulated significant amounts of goodwill some extra time to comply with the new standards.

Phase Out Prior to Maturity. Second, we would suggest that during the last five years before the underlying subordinated note matures, that the associated trust preferred securities be gradually phased out (20% per year) as tier 1 capital and included in tier 2 capital. The Board's proposal requires that outstanding amount of trust preferred securities must be excluded from tier 1 capital and included in tier 2 capital starting at the beginning of the five year period. Our suggestion would allow a community bank to replace the tier 1 capital over a five-year period rather than having to replace it during the first year of the change.

Treatment of Trust Preferred Securities Issued by Small BHCs. Third, ICBA recommends further analysis before changing the treatment of trust preferred securities issued by small BHCs.

The Board is considering clarifying either by rulemaking or through supervisory guidance the treatment of qualifying trust preferred securities issued by small BHCs (that is, BHCs with consolidated assets of $150 million or less) under the Small Bank Holding Company Policy Statement, which generally exempts small BHCs from the Board's risk-based capital and leverage capital guidelines.[5] One approach being considered by the Board is to generally treat the subordinated debt associated with trust preferred securities issued by small BHCs as debt for most purposes under the Small BHC Policy Statement, except that an amount of subordinated debt up to 25% of a small BHC's GAAP total stockholders' equity, net of goodwill, would be considered as neither debt nor equity under the Small BHC Policy Statement.

ICBA is concerned that small BHCs with significant amounts of debt or goodwill could be adversely impacted if the Board were to suddenly change its policy and require that subordinated debt associated with trust preferred securities be included as debt for purposes of the Small BHC Policy Statement. This would be particularly true of small BHCs that have accumulated substantial debt as part of an acquisition program or change in control, or at the time their holding company was formed—the very banks to which the Small BHC Policy Statement applies.

ICBA recommends that before considering any change to the treatment of trust preferred securities issued by small BHCs, the Board first analyze the impact on small BHCs of any such change and seek additional comment, through a rulemaking procedure, on specific approaches. At a minimum, ICBA would recommend that existing issuances of trust preferred securities by BHCs subject to the Small BHC Policy Statement be

[5] The Small Bank Holding Company Policy Statement is at 12 CFR Part 225 Appendix C

grandfathered and/or that any change be gradually implemented over a transition period of at least five years.

Consistent with ICBA's past position, we urge the Board to increase the size limit for BHCs that wish to qualify as small BHCs and be subject to the Small Bank Holding Company Policy Statement.[6] The current $150 million limit has not been changed since 1972. We recommend increasing it to at least $500 million to enhance the ability of community banks to remain independent. Increasing the exemption to $500 million would improve the ability of community banks to sell their stock locally, keeping the financial decisions affecting the community in the local area.

Conclusion

ICBA commends the Board for proposing the retention of trust preferred securities as tier 1 capital. For community bank holding companies, the issuance of trust preferred securities have become an important vehicle for raising capital. As the Board has observed, no alternative tier 1 structure to trust preferred securities has emerged that can be similarly pooled and issued to the capital markets by community bank holding companies. An immediate change in the Board's policy would have adversely impacted community banks and their ability to lend. A change in accounting treatment for trust preferred securities does not change the underlying equity features that make them available to absorb losses and, therefore, appropriate to include as a limited element of regulatory capital.

Although ICBA supports the proposal, we recommend further changes to the proposal including a longer transition period for banks that have accumulated goodwill and a phase out for including trust preferred securities as tier 1 capital during the five year period prior to the maturity of the subordinated note. We would also increase the size limit for BHCs that wish to qualify as small BHCs under the Small Bank Holding Company Policy Statement, and urge the Board to seek further comment on any specific approaches to clarifying treatment of trust preferred securities issued by small BHCs.

If you have questions or need any additional information, please do not hesitate to contact me at 202-659-8111 or at Chris.Cole@icba.org.

Sincerely,

Christopher Cole

Christopher Cole
Regulatory Counsel

[6] ICBA (then the Independent Bankers Association of America) petitioned the Board in 1989 to increase the limit to $500 million and later in 1996, urged the Board to increase the limit when the Board considered revisions to Regulation Y.